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William W. Bratton

University of Pennsylvania Carey Law School

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THE ECONOMIC STRUCTURE OF THE POST- CONTRACTUAL CORPORATION

William W. Bratton*

I. INTRODUCTION

The political economics of corporate law changed abruptly during the 1980s. At the decade's start, the prevailing economics counseled that excess management power needed to be curbed for productivity's sake. Law reform was assumed to be an appropriate means to this end.¹ But this antimanagerialist paradigm fell from favor, and by the time the takeover market became white-hot in 1984 and 1985, a "contract paradigm" had taken its place. The large American corporation reemerged as a nexus for a set of contracts among individual factors of production.² Corporate governance followed suit, and reappeared as a field well suited to microeconomic modeling. By the time the stock market crashed in 1987, academic corporate law's determinant presumptions had been reversed. Credit for this change goes in the first instance to Professor (later Judge) Frank Easterbrook and Professor Daniel Fischel, the leading exponents of the new "contractarian" view.

Easterbrook and Fischel led corporate legal theory up the mountain of contract. They restated every topic of consequence in the terms of financial economics. In so doing, they captured the rhetoric of academic corporate law, rewriting the story of shareholder-management relations to accord with a theme of self-protection through contract.³ Where once we had shareholder dependence, they substituted cheap opportunities to

* Professor of Law, Rutgers School of Law. My thanks to Pete Malloy, Denis Segota, and Rich Shorten for research assistance.

¹ The leading commentaries advocated federal controls. See JOEL SELIGMAN, RALPH NADER & MARK GREEN, *TAMING THE GIANT CORPORATION* (1976); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

² This standard formulation came from Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

The "contract paradigm" is the law and economics model of the corporation and corporate law. It depicts all corporate participations as contractual relationships and looks to microeconomic models of optimal contracts for normative guidance. It should be distinguished from an older legal model of the corporation and corporate law. The legal model subordinates contractual participation to government creation and control and places normative emphasis on the positive law containment of corporate power.

³ Easterbrook and Fischel's contractual self-protection story is retold *infra* in text accompanying notes 28-38.

diversify firm-specific risk. Where once we had unfair wealth transfers, they substituted market pricing that accounted for the risks of misallocated gains. Where we once had excess management power, they substituted market constraints. Where we once had "needs" that called for reform, they substituted "costs" that blocked reform.

Now Easterbrook and Fischel summarize their enterprise with *The Economic Structure of Corporate Law*.⁴ This long-awaited⁵ book collects, highlights, and integrates their foundational pieces⁶ so as to give us a touchstone volume. This book provides a corporate law counterpart to Judge Posner's *Economic Analysis of Law*,⁷ and a counter to Professor Eisenberg's positivist account, *The Structure of the Corporation*.⁸ No other contemporary book about corporate doctrine approaches its theoretical force.⁹ It may be that no comparable integration of corporate law and economics has appeared since 1934, when Berle and Means published *The Modern Corporation and Private Property*.¹⁰

Then again, perhaps Easterbrook and Fischel's book should not be compared directly with *The Modern Corporation and Private Property*. The Berle and Means book set the paradigm for a half-century of corporate law discourse. *The Economic Structure of Corporate Law* cannot replicate this feat, even if the contract paradigm holds sway for its own half-century. This book, after all, appears *ex post*. The contract paradigm is by now long established. Moreover, it seems unlikely to stay in ascendance for a half-century, as the political economics of corporate law have begun to shift again.

Easterbrook and Fischel's book is not quite in step with the new politics. Their contractual construct's three foundations—investor self-

⁴ FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

⁵ The book was promised in a number of the component articles. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985).

⁶ The result is a book sufficiently accessible to provide instructors and students with a plausible theoretical companion to the casebook. Here they succeed where a preceding book of excerpts, RICHARD A. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* (1980), did not.

⁷ RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (3d ed. 1986).

⁸ MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976).

⁹ This does not go to say that important books bearing significantly on corporate law have not appeared. Consider, for instance, the entire field of organizational economics. See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (1985). But we need not stop there. See, e.g., MEIR DAN-COHEN, *RIGHTS, PERSONS AND ORGANIZATIONS: A LEGAL THEORY FOR BUREAUCRATIC SOCIETY* (1986); IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* (1980).

¹⁰ ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (reprint ed. 1982).

protection, market price, and market constraint—operate with less force today than they did ten years ago. Recent events have diminished market constraints and make investor self-protection seem a less plausible governance tool. Takeovers have disappeared along with easy credit. As real life Gordon Gekkos¹¹ have gone to jail,¹² managers have climbed back into the saddle—as ineffective and self-serving as ever, according to their mainstream critics.¹³ Commentators today assume the inadequacy of market constraints as they encourage institutional investors actively and collectively to assert themselves in corporate governance.¹⁴ In the new context, investor self-protection is not an accomplished fact, but an aspiration to be realized through exhortation,¹⁵ novel economic analysis,¹⁶ or law reform.¹⁷ Corporate law seems to have ended the 1980s at the same point where it began them—grappling with the problem of excess management power in the Berle and Means corporation.¹⁸

¹¹ This character in the movie *WALL STREET* (Twentieth Century Fox 1987) embodied the capital market actors providing the motive power for the market constraint story. For a discussion of this, see Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1975-76 (1991).

¹² See JAMES B. STEWART, *DEN OF THIEVES* 446-49 (1991).

¹³ This year's leading corporate problem is management pay; it has, apparently, gone out of control. Criticism of "excessive" compensation of America's top executives is widespread. It has gotten to the point where Congressmen implicate executive pay as a principal element in America's decline in productivity and world competitiveness. See *Hearing on Corporate Pay Responsibility Act Before the Senate Subcommittee on Securities*, 102d Cong., 1st Sess. (Oct. 17, 1991) (statement of Senator Levin).

Traditionally, executive compensation practice has been justified on the existence of a market for labor. See generally Symposium, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 1 (1985). Today's critics charge that this market is intentionally designed to eliminate the possibility that a corporation ever pays below the market average. The system is an internal ratchet mechanism which causes pay to spiral upward. See GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS* 9-15, 42-50 (1991) (providing anecdotal evidence). Even strict supporters of the market view are beginning to concede that this market does not operate flawlessly. See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay But How*, HARV. BUS. REV., May-June 1990, at 138 (asserting that salaries and bonuses are not too high, but conceding that pay and corporate performance are not properly correlated).

¹⁴ See, e.g., John Pound, *Beyond Takeovers: Politics Comes to Corporate Control*, 70 HARV. BUS. REV., Mar.-Apr. 1992, at 83, 85-87.

¹⁵ Ronald J. Gilson & Reiner Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991) (urging voluntary monitoring organization).

¹⁶ Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

¹⁷ John C. Coffee, Jr., *Liquidity versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1355-57 (1991).

¹⁸ This does not go to say that Easterbrook and Fischel's effort to put the legal corporation on a different theoretical footing has had no effect on this discourse. Although the old "separation of ownership and control" is back with a vengeance, it is back in a different form. Today we address it as a question of agency cost control. Present organizational patterns are suboptimal and require reconstruction. This is taken up in the first instance as a matter of rewriting the organizational contract—a deregulatory regulatory discussion.

This discourse creates a roadblock in the way of continued use of the nexus-of-contracts concept only if exhaustive discussions lead to the creation of no effective contractual means to solve the

One picks up *The Economic Structure of Corporate Law* looking to see how these recent developments impact on Easterbrook and Fischel's amended presentation. On the surface, little seems to have changed.¹⁹ Easterbrook and Fischel still seem to consider the economic barriers to shareholder control through the vote to be insurmountable. In their view, no shareholder holding less than one hundred percent has the right incentives, and the shareholder collective action problem can best be surmounted by aggregating shares through mergers and tender offers.²⁰ Recent developments respecting the market for corporate control are given extended treatment. But even here Easterbrook and Fischel are selective. They take up the state antitakeover statutes,²¹ but make no mention of the finance-driven reduction of merger and acquisition activity. They prominently display recent empirical work proving that tender offers result in positive returns to equity holders.²² But they do not mention a pending empirical question about the trade-off between these gains and the bankruptcy costs incurred during the present recession.

These are incidental shortcomings, however. The book may not address itself to all issues of the day, but its model has ample capacity to provide for these issues when the occasion to address them arises. In fact, as restated in the book, the model is capacious enough to allow for virtually automatic accommodation of most changes in the mainstream politics of corporate law.

The model's provision for moderate results comes as a surprise. Although Easterbrook and Fischel were the undisputed leaders of the 1980s' contractarian movement, they were not known as the voices of the mainstream contractarian position. Easterbrook and Fischel like to insist that contract succeeds. True to the Chicago tradition of law and neoclassical microeconomics, they tend to accord determinative force to the triumvirate of investor self-protection, market price, and market constraint. The corporate law mainstream, in contrast, holds open a door to

problems of corporate governance. This is an active possibility. It is not unlikely that the current round of instruction will fail to prompt active participation by institutional equity investors—either because investment institutions operate subject to their own heavy agency costs, or because activism does not turn out to be cost effective for the vast majority of institutions. These points are put forcefully in Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

¹⁹ No doubt we will hear from Easterbrook and Fischel on this subject in the future.

²⁰ EASTERBROOK & FISCHEL, *supra* note 4, at 67. Thus, when Easterbrook and Fischel take up proxy regulation they assume the cost effectiveness of institutional investor passivity and go on to refight an old battle against the corporate governance movement of the 1970s. *Id.* at 88-89. Pointing this out does not imply criticism. This approach very well may be correct. See *supra* note 18.

Concern about management salaries appears in the book only by implication. In the course of their discussion of insider trading, Easterbrook and Fischel note that if insider trading profits are exploitative of shareholders, we therefore have to worry about all salaries. EASTERBROOK & FISCHEL, *supra* note 4, at 262. Today, salaries are a public policy worry. See *supra* note 13.

²¹ EASTERBROOK & FISCHEL, *supra* note 4, at 212-27.

²² *Id.* at 190-98.

the proposition that contract can fail. It follows an economic model of the contractual firm, drawn from the work of Oliver Williamson and built around a recognition of contract failure. In this model the failure sometimes occurs because the pursuit of rational self-interest goes overboard, becoming suboptimal opportunism. At other times, the failure occurs because of intrinsic limits on the problem-solving abilities of contracting parties.²³ Either way, contract failure causes economic actors to build compensating governance structures, and sometimes even justifies government regulation.²⁴

Review of the works collected in *The Economic Structure of Corporate Law* prompts reappraisal of Easterbrook and Fischel's reputation as neoclassical critics of the rest of the legal academy. They prove quite sensitive to the flow of the corporate law mainstream. When the moment for concrete decision arrives, they tend to find a way to join it. Much of the talk to the effect that market and other contracting processes achieve pricing solutions to every problem in corporate governance turns out to be just talk. They often conclude that the market or other contract process in question has failed or arguably failed, and that regulation by statute or judicial intervention may be justifiable. As applied, if not as stated, their model is thoroughly Williamsonian.

Easterbrook and Fischel are so astute that they keep a safe distance from the assertion that the corporation is a nexus of contracts. The book delimits and subordinates this once foundational proposition. This is an appropriate step. The claim that everything in corporate life and law is contract at some deep structural level has outlived its usefulness. The idea never worked all that well as it was. Its shortcomings have been exhaustively discussed.²⁵ It had heuristic value²⁶ ten years ago, when microeconomic models of corporate structure were new to law. At that time the nexus-of-contracts assertion taught the lesson that the models have a valid bearing on legal corporate governance. Now that the lesson has been learned and, indeed, now that the rhetoric and politics of the entire field have been captured and tamed, the nexus-of-contracts theory no longer needs emphasis. Its heuristic value has been spent. Economic analysis can proceed without it on the uncontroverted assumption that the corporation has significant contractual aspects.

²³ See Williamson, *supra* note 9, at 45-61, 294-97, 301-02; Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537, 1544-46 (1981).

²⁴ See *infra* text accompanying notes 85-89.

²⁵ See, e.g., Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Paul N. Cox, *Reflections on Ex Ante Compensation and Diversification of Risk as Fairness Justifications for Limiting Fiduciary Obligations of Corporate Officers, Directors and Controlling Shareholders*, 60 TEMP. L.Q. 47 (1987); Lynne L. Dallas, *Two Models of Corporate Governance: Beyond Berle and Means*, 22 U. MICH. J.L. REF. 19 (1988).

²⁶ That is, it taught us to see the contractual aspects of an area of law previously thought to be largely constituted of sovereign directive. See Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 670 (1989).

The Commentary that follows expands on these observations. Part I highlights the mainstream aspects of *The Economic Structure of Corporate Law*. It also reports on the rapidly diminishing status of the theory of the nexus-of-contracts corporation. It offers a simple explanation for these themes. The assertion "it takes a theory to beat a theory" is not strictly correct. A theory indeed may beat a theory. Nothing, however, beats a theory like a practice, and reference to practice makes the pure contractual corporation untenable.

Part II extends this critical reading of the book to two particular topics as to which Easterbrook and Fischel retain a distinct profile as the market current of the corporate law mainstream. The first is their strong position against judicial imposition of gain sharing in corporate control transactions, based on their assertion that the content of the legal norm of shareholder expectations should be drawn from first generation financial economic models. This Commentary's argument in response notes the persistent appearance of gain sharing rules in corporate law and highlights its economic rationality. The second topic is Easterbrook and Fischel's strong, cost-based presumption against the creation of additional corporate law. The argument in response questions the materiality of the asserted costs and the effectiveness of market-based enforcement substitutes.

Part III makes two affirmative assertions to counter and substitute for the economic theory of the firm as presented by Easterbrook and Fischel. First, corporate entities persist in corporate law because "organization" as well as "contract" remains central to our experience of corporations. An effective theory of the corporation therefore must explain the entity's persistence in economically and politically acceptable terms. Second, a new heuristic is proposed to fill the theoretical space opened by the disappearance of the nexus-of-contracts theory of the firm. It is suggested that the corporation is a complex of relationships—legal, political, and social, as well as economic—and that corporate law mediates between actors and concepts in the complex. Seeing corporate law as a mediative device²⁷ makes possible a more plausible synthesis of microeconomics and existing legal structure than does the model set out in *The Economic Structure of Corporate Law*.

²⁷ This "mediative" approach to corporate law is a mode of describing and explaining the law that draws on the common-law tradition of practical reason. Such descriptions admit theoretical instability and complexity where the economic paradigm demands theoretical consistency. Their function, therefore, is primarily critical. This "mediative" conception does not amount to a normative model that purports to offer correct solutions to legal problems. For an extended explanation, see *infra* Part III.

II. THE GOING CONCERN

A. *Components of the Economic Model*

1. *Mythic Origins.*—Easterbrook and Fischel bring a familiar bundle of assumptions to bear in their model of corporate law. Here free choice, intense competition, rational self-interest, and contractual risk-allocation determine the life of the large corporation.

It all begins with a creation story²⁸ in which corporate governance provisions originate at the transactional margin. In the beginning, owner-managers go public, selling equity securities to outsiders.²⁹ The selling managers make determinant choices³⁰ of jurisdiction³¹ and governing terms.³² But, because this generative public offering occurs in a competitive market, they have an incentive to choose terms that meet the expectations of the security-holding public. If they offer the wrong terms, they get paid less for their securities.³³

The story denudes management of significant power to engage in suboptimal self-serving behavior. The purchasing shareholders, being rational economic actors, assume that the selling managers will engage in self-serving behavior at holders' expense. They accordingly bid down the stock. This gives the selling managers an incentive to build in governance devices that control their own misbehavior.³⁴

After the moment of creation, market controls take over. Competition in markets for employment, products, and corporate control keeps managers in line.³⁵ At the same time, stock market prices, which take governance problematics into account,³⁶ effectively protect new investors by bringing them in at a risk-adjusted rate of return and providing them a low-cost means of evaluating management's performance.³⁷ Over time, competition in the marketplace favors the survival of maximizing governance terms.³⁸

2. *The Presumption Against Regulation.*—The creation story opens the door for one of Easterbrook and Fischel's main points about corporate law: that there should be a presumption against having any more of it than already exists. The actors create governance terms, and the mar-

²⁸ This is drawn from the basic economic text, Jensen & Meckling, *supra* note 2.

²⁹ EASTERBROOK & FISCHEL, *supra* note 4, at 6.

³⁰ *Id.* at 4.

³¹ *Id.* at 5.

³² *Id.* at 6.

³³ *Id.*

³⁴ *Id.* at 7.

³⁵ *Id.* at 4, 91, 96-97.

³⁶ *Id.* at 18.

³⁷ *Id.* at 19-21, 93 (discussion of market price sensitivity to changes in governance; direct monitoring too costly).

³⁸ *Id.* at 6, 13.

ket prices them. Therefore, terms mandated by law are justifiable only if "the terms chosen by firms are *both* unpriced and systematically perverse from investors' standpoints."³⁹

Easterbrook and Fischel make their market governance case with care. Their system is substantially—not absolutely—effective. No strong form market efficiency assertion appears: they assume that real world market prices do not perfectly reflect all risks all the time. Even so, Easterbrook and Fischel make a strong claim for institutional primacy for the market price. The market, they say, does the best available evaluative job. The evaluation is thorough-going, even extending to governance terms.⁴⁰

Easterbrook and Fischel also stop short of claiming that market forces build an absolute barrier to inefficient managerial self-service. Here the law assists the market, fleshing out voluntary governance terms with gap-filling fiduciary duties.⁴¹ Easterbrook and Fischel's managers also make questionable allocative decisions. But, as to these, Easterbrook and Fischel take a deregulatory position. They make a strong claim respecting investor expectations, asserting that investors do not require legal protection. Risk-averse equity investors protect themselves from this conduct through portfolio diversification. Those who do not diversify fully are not risk averse.⁴²

What investors expect, say Easterbrook and Fischel, is whatever maximizes firm value,⁴³ and, as between longstanding voluntary relations and regulation, the former are entitled to the presumption of efficiency.⁴⁴ A showing of wrongdoing does not, in and of itself, justify regulation.⁴⁵ Those who argue to the contrary subscribe to the "Nirvana fallacy"—the incorrect assumption that everything can be made perfect.⁴⁶ Easterbrook and Fischel counsel against regulation even where a plausible, but arguable, case for a mandated governance improvement has been made. Under the creation story, corporations can always opt-in to the rule in their certificates of incorporation.⁴⁷ And, on the rare occasion when the case for intervention is clear cut, deterrent liability rules fare better than regulatory supervision.⁴⁸

³⁹ *Id.* at 21 (emphasis in original).

⁴⁰ *Id.* at 18-19.

⁴¹ *Id.* at 92-93.

⁴² *Id.* at 29-30. Presumably they require no legal assistance. It should be noted that Easterbrook and Fischel extend this judgment only to stock-pickers. The other main class of undiversified investors—managers—are risk-averse, and their risk-aversion causes agency costs. *Id.*

⁴³ *Id.* at 23.

⁴⁴ *Id.* at 82.

⁴⁵ *Id.* at 7.

⁴⁶ *Id.* at 303.

⁴⁷ *Id.* at 204-05 (discussing auctions in control contests). *Cf. id.* at 263 (possibility of contracting to bar insider trading).

⁴⁸ *Id.* at 7.

3. *The Economic Rationality of the Law*.—Easterbrook and Fischel articulate a structural legal theory founded on a presumption against new positive law. Such theories have radical implications. If new law is inappropriate today, then existing law probably was inappropriate at the moment of its formulation. A prescription for mass deregulation appears to follow. Easterbrook and Fischel do not move in this direction, however. Their presumption against regulation does not invite general deregulation, but instead operates as a corollary to their second main point: that economic rationality is implicit in corporate law.⁴⁹

The economic rationality proposition is the tie that binds together this collection of essays. The book, as it were, shows students how economic rationality determines the content of every chapter in the Corporations casebook. The student learns that the doctrine of disregard of the corporate fiction is rational.⁵⁰ In addition, the rules on shareholder voting⁵¹ and close corporations⁵² are rational. Economic rationality also justifies the duties of loyalty⁵³ and care,⁵⁴ most appraisal rights schemes,⁵⁵ and the law of damages.⁵⁶ Even the rules on shareholder derivative actions pass inspection, albeit barely.⁵⁷

Easterbrook and Fischel treat the federal securities laws with considerably more suspicion and, indeed, equivocation. They present spirited arguments against and in favor of both the insider trading prohibition and the mandatory disclosure system. In the end, they allow that economic rationality may support regulation in certain circumstances.⁵⁸ Only federal regulation of proxy solicitation and recent antitakeover developments are subject to open condemnation.⁵⁹

This cumulative showing of economic rationality across the outline of basic corporate law is the book's principal contribution. The eco-

⁴⁹ *Id.* at 315. Their regulatory politics, accordingly, are more Tory than radical conservative.

⁵⁰ *Id.* at 55.

⁵¹ *Id.* at 63-70.

⁵² *Id.* at 228-52.

⁵³ Even as applied to sales of controlling blocks of stock, corporate opportunities and cash-out mergers. *Id.* at 109-44. Here I would take the position that Easterbrook and Fischel have to mischaracterize the doctrine in order to fit it into their particular economic rationality framework. See *infra* notes 115-125 and accompanying text.

⁵⁴ EASTERBROOK & FISCHEL, *supra* note 4, at 90-91.

⁵⁵ *Id.* at 161.

⁵⁶ *Id.* at 315-16.

⁵⁷ Easterbrook and Fischel are suspicious of the derivative action as a value-maximizing device, but do not condemn it out of hand. *Id.* at 100-02, 105-06.

⁵⁸ *Id.* at 262-63, 302-03. In their mandatory disclosure discussion, Easterbrook and Fischel offer a surprisingly warm endorsement of the hard information disclosure system of two or three decades ago. *Id.* at 289-90. Every conventional justification of the federal securities laws is, of course, dismissed out of hand. See, e.g., *id.* at 296-300 (increasing investor confidence in the marketplace by protecting unsophisticated investors and increasing supply of truthful information).

⁵⁹ *Id.* at 84-85 (shareholder proposal Rule 14a-8 is not cost efficient or democratic), 196-97 (reduction in value of firms protected by antitakeover provisions).

conomic rationality of many corporate law topics is far from obvious *ex ante*. The model has to be expanded and manipulated to accommodate them.⁶⁰ It takes considerable analytical skill to build the case as persuasively as Easterbrook and Fischel do here.

This is not the Easterbrook and Fischel one remembers from the law reviews of the 1980s. In their separate articles, the normative struggle against regulation seemed to take first place on the agenda. But memory does not serve correctly.⁶¹ The ratification of existing law has shared first place on Easterbrook and Fischel's agenda with the presumption against regulation all along. The two always have been closely intertwined in their model.⁶² In fact, a successful ratification exercise is mandated by the model's very terms. As tends to be the case in law and economics, Easterbrook and Fischel's theory asserts the evolutionary dominance of conduct motivated by economically rational choice. For the theory to be proved valid, these forces must have a determinant role in the explanation of existing law. The ratification exercise also is central to the campaign to contain law reform and undermine academic theories that encourage reform. Ratification, after all, implies normative approval of the status quo. Happily, it does not also imply stasis. Economic conditions change, and as that happens, competitive forces change law (although no doubt Easterbrook and Fischel would find that the changes take a deregulatory turn).

Memory serves incorrectly here due to changes of time and context. The articles appeared at a time of theoretical instability. They addressed the immediate objectives of introducing a new rhetoric for academic discourse and capturing the normative high ground with a welfare concept defined in neoclassical microeconomic terms. What lingers in the memory, then, is their destabilizing rhetoric and aggressive deployment of the presumption against new regulation. A new encounter with the articles, as presented in the book, shows that the ratification exercise also figured into Easterbrook and Fischel's rhetorical campaign. Easterbrook and

⁶⁰ As a result, the economic model's parameters expand. See *infra* text accompanying notes 85-91.

⁶¹ My initial response to the book's insider trading and mandatory disclosure discussions, see *supra* text accompanying note 58, was to ask whether these amounted to substantial revisions of Easterbrook and Fischel's prior work on these topics. Surely the earlier articles took stronger positions on the sufficiency of market processes and recommended substantial law reform. A check showed that my memory disserved me. Tentative justifications of the status quo are set out in the precedent works. See Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 81 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984). But see Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983) (suggesting that extensive regulation of insider trading is unwarranted).

⁶² See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 109-17 (1985) (existing law of piercing the corporate veil efficient, alternatives probably costly).

Fischel introduced a new paradigm with a new vocabulary and different norms. A new paradigm's case as a replacement for a prevailing paradigm is strengthened by consonance with the inherited juridical construct. Indeed, this consonance is necessary for plausibility in a conservative context. The new theory transforms not the law, but the language of discussion and the underlying normative presumptions. Then, as events unfold, the new discourse (and, in this case, the presumption against new regulation) comes to bear on the treatment of new issues.⁶³

Today, of course, the campaign has ended with victory achieved. Easterbrook and Fischel address the book to a discourse in which their rhetoric is familiar and their welfare concept prevalent. In this clearer atmosphere, the ratification story becomes ripe for evaluation.

In theory, the radical deregulatory rhetoric of Easterbrook and Fischel's creation story meshes perfectly with the ratification of what is, after all, a substantial body of regulation. But, in fact, a tension persists between the two. The ratification occurs *ex post*. The law thus ratified was not formulated by reference to the economic model.⁶⁴ It tends to be formulated in doctrinal systems that are self-referential, although highly sensitive to all currents of the outside political economy. The law also tends more often to result from judgments between competing principles than from deductions from first principles. The rationality that informs it is more practical than economic.⁶⁵ Rational economic explanations must be devised after the fact to accord with a broader theoretical program. Tailoring these explanations to fit awkward institutional realities takes skill and effort,⁶⁶ as Easterbrook and Fischel's book shows. The completed ratification gives rise to a question: Whether, if reference had been made to the economic model at the time of the law's formulation, the law in question ever would have gotten onto the books. As an example, consider Easterbrook and Fischel's conclusion that the insider trading prohibition and the mandatory disclosure system may be economically beneficial. It is hard to imagine that, applied *ex ante* by Easterbrook and Fischel or anyone else, the model would lead to that conclusion. The blunt self-protection story and presumption against regulation would overwhelm the artfully constructed justifications that the book presents.

⁶³ If, in the future, a segment of the duly ratified body of existing law comes up for reconsideration, it might well prove to lack economic rationality.

⁶⁴ Of course this is changing. See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (relying on the fraud-on-the-market theory); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

⁶⁵ See *infra* text accompanying notes 172-77.

⁶⁶ In addition, it gives the academic an excellent opportunity for demonstrating his or her skills.

B. The Disappearing Nexus of Contracts

The foregoing describes Easterbrook and Fischel's going concern without mentioning the nexus-of-contracts corporation. In making this omission, the description follows the lead of the book. Though the book leads off with the topic of the contractual corporation, it does not present quite the same nexus-of-contracts corporation that Easterbrook and Fischel formerly presented as their paradigm's foundational concept.⁶⁷ As the following discussion shows, the emphasis has changed.

1. *Containing the Nexus of Contracts.*—Easterbrook and Fischel pause at the book's start to "step back and ask whether corporation-as-contract is a satisfying way of looking at things even in theory."⁶⁸ To all appearances the proposition survives inspection. But the process drains off much of the content.

Easterbrook and Fischel make an uncharacteristically half-hearted case.⁶⁹ The corporation, they say, is contractual in nature because it is a "voluntary" and "adaptive" "complex [of] arrangements."⁷⁰ This statement is true, but it does not support the old paradigm. Today's United States Army is also a "voluntary" complex of arrangements.⁷¹ Yet the Army's norm of sacrifice and structure of command make a contractual description unhelpful. As to "adaptive" capacity, the Delaware courts and legislature perform better in a dynamic economic environment than do, for instance, the car companies. Yet few would find it useful to describe state government as a nexus of contracts.

Easterbrook and Fischel do not bother to pursue the claim that corporate law is contractual at a deep structural level even when mandatorily phrased. It is just, they say, that the voluntary is more important than the mandatory to everyday operation and ultimate welfare.⁷² This is another true statement. But it is a statement no observer would have bothered to dispute back in 1968, when the Second Circuit decided *Texas Gulf Sulphur*.⁷³ Nor do Easterbrook and Fischel claim

⁶⁷ For an unqualified statement of the contractual theory of the firm, see Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 401 (1983). See also Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261-62 (1982). For a more careful, but still unqualified statement see Frank H. Easterbrook & Daniel Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 283 & n.36 (1986).

⁶⁸ EASTERBROOK & FISCHEL, *supra* note 4, at 7.

⁶⁹ The bald claim that corporate law is just contract law on a large scale with no other meaningful content does not show up often in the book. *Id.* at 90, 166.

⁷⁰ *Id.* at 12, 15-22. This part of the book repeats observations from Easterbrook & Fischel, *The Corporate Contract*, *supra* note 5, at 1426-47.

⁷¹ Indeed, Easterbrook and Fischel note that some corporations are hierarchies with command structures. EASTERBROOK & FISCHEL, *supra* note 4, at 12.

⁷² *Id.* at 3. Furthermore, the theorist must account for both aspects. *Id.*

⁷³ *Securities and Exch. Comm'n v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

that agency-cost analysis leads to some necessarily contractual bottom line. Instead, they look for the balance of advantages among the various devices that control agency costs,⁷⁴ and not all of these are contractual.

Easterbrook and Fischel do continue to employ a "contractual" normative yardstick. The law, they say, should replicate the contract the parties would have reached if left to themselves in a low-cost world.⁷⁵ But deciding to bring a hypothetical contract norm to bear on corporate law questions does not, as a positive proposition, make the corporation a nexus of contracts. Hypothetical contract is a welfare norm asserted by an academic. It is not a transactional artifact. In Easterbrook and Fischel's construct, the "contractual" analytical product is imposed without regard to whether the real-world actors in a situation of higher cost and bounded rationality would have employed it themselves if offered the chance. Here, if the issue ever is joined, welfare trumps choice.

When *The Economic Structure of Corporate Law* deals with internal corporate problems in contractual terms, it brings to bear the relational contract paradigm.⁷⁶ This is a telling theoretical choice. Easterbrook and Fischel avoid modeling internal relationships in the discrete transactional terms that prevail in neoclassical microeconomic analyses of corporate arrangements.⁷⁷ They conceive of interactions inside the firm in terms of "team" or "cooperative" production,⁷⁸ rather than in strict terms of exchange. The actors, they say, cannot cost effectively solve all problems *ex ante* with contracts. Accordingly, judicial intervention provides an effective backstop for answering such questions.⁷⁹ Their model restricts discrete exchange to the stock market, the venue where it occurs in practice.⁸⁰ If Easterbrook and Fischel were not the authors, this discussion would garner the appellation "Williamsonian"⁸¹ as a matter of course.

⁷⁴ EASTERBROOK & FISCHEL, *supra* note 4, at 14.

⁷⁵ *Id.* at 15.

⁷⁶ For example, they say corporate law interpolates fiduciary duties as gap-fillers, not merely to save the parties some small change at the drafting table but because the range of problems is too open-ended to be subject to effective drafting solutions. *Id.* at 90-91.

The discussion of the judicial role in close corporation disputes also amounts to relational contract treatment. Easterbrook and Fischel acknowledge the ambiguities intrinsic to situations in which the parties omit to supply contract terms, and also make the sensible suggestion that judges intervening in close corporation disputes should look to the drafting pattern emerging in larger, more exhaustively drafted enterprises. *Id.* at 238, 245, 250-52. See also *id.* at 66 (voting as a means to make decisions not provided by contract).

⁷⁷ For examples of such an analysis, see Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, *supra* note 2, at 312-19.

⁷⁸ EASTERBROOK & FISCHEL, *supra* note 4, at 9. Here they draw not on Jensen and Meckling, but on the precedential work of Alchian and Demsetz. See Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

⁷⁹ EASTERBROOK & FISCHEL, *supra* note 4, at 35.

⁸⁰ See, e.g., *id.* at 17-22.

⁸¹ See *supra* notes 23-24 and accompanying text.

Given all of this, what was that nexus-of-contracts corporation all about in its day? The book provides an accurate answer:

The arrangements among [corporate actors] usually depend on contracts and on positive law, not on corporate law or the status of the corporation as an entity. More often than not a reference to the corporation as an entity will hide the essence of the transaction. So we often speak of the corporation as a "nexus of contracts" or a set of implicit and explicit contracts

...⁸²

The nexus-of-contracts assertion, then, deflects attention from the shopworn juridical corporation, with its shareholder "owners," and its long history of conceptual concern for the role and meaning of the "corporate entity."⁸³ Clearing out this juridical clutter frees us to concentrate on economic fundamentals. We demystify the shareholders, now seeing them as investors who happen to have agency cost problems in their relationship with another group of corporate participants, the managers.⁸⁴ Thus described, the "nexus of contracts" is not a positive and normative foundation for corporate legal theory, nor even much of an heuristic. It is a point of critique.

2. *The Containment Explained.*—Easterbrook and Fischel have stepped back from the nexus-of-contracts corporation because developments in both theory and practice made manifest its inadequacy as a foundation for any plausible legal theory. The theoretical development was the "mandatory/enabling" discussion of the late 1980s. This showed that shareholder-manager relationships did not, in the main, lie within the zone of free contract. The practical development was the failure of crucial subject matter—the law addressed to takeovers—to develop in conformity to the model's predictions. This showed emphatically that corporate law does not always instantiate contractual norms. The fact that these two topics had been the principal focus of corporate legal scholarship for a number of years made these developments doubly debilitating for the proposition that corporations are comprised of a nexus of contracts.

(a) *Mandatory corporate law affirmed.*—The mandatory/enabling discussion was an extended consideration of the implications of the nexus-of-contracts proposition. The proposition on the table was this: If the firm is contract, then the parties in interest should be able to "opt-out" of the terms provided by state law and substitute their own terms. Discussion of this proposition iterated contract law's "overreaching" analysis. It turned out that process defects make the corporate charter

⁸² EASTERBROOK & FISCHEL, *supra* note 4, at 12.

⁸³ Easterbrook and Fischel see the "corporate entity" as a convenient form for organizational action. *Id.*

⁸⁴ *Id.* at 10-11. Easterbrook and Fischel thus confront the separation of ownership and control without denominating it as such, and cast this dichotomy in terms of risk-bearing roles.

amendment an inappropriate context for complete freedom of contract, even when viewed through the lens of an economic model. Shareholders have a collective action problem when managers propose charter amendments. Small stakes make it irrational for individual holders to invest in information acquisition.⁸⁵ Moreover, managers, by virtue of their control of the structure and timing of the amendment process, can easily turn the shareholders' disadvantaged negotiating position to their own advantage.⁸⁶ The upshot is a contract failure: the shareholders rationally vote to approve an amendment that decreases value to them.

A consensus of sorts emerged from the discussion. The amendment process is deemed reliable as to amendments such as poison pills or stock option plans that are company-specific and transaction-specific. But, as to general, open-ended proposals such as a broad-brush abolition of director and officer fiduciary duties,⁸⁷ contract failure is probable. Therefore, according to the consensus, charter amendments sometimes should be subject to mandatory regulation even under a contract paradigm.⁸⁸

⁸⁵ See, e.g., John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 934 (1988) [hereinafter Coffee, *No Exit*]; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1577 (1989).

⁸⁶ Gordon, *supra* note 85, at 1577-84. Coffee stressed this problem of "agenda manipulation" over the rational apathy story. He pointed out that shareholders can easily just say no, but that management's ability to manipulate the agenda stilt the whole corporate contracting process. John C. Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1675-76 & n.234 (1989) [hereinafter Coffee, *Mandatory/Enabling*].

⁸⁷ See Coffee, *Mandatory/Enabling*, *supra* note 86, at 1664-65; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1469-70 (1989) (close corporations); Gordon, *supra* note 85, at 1593-97.

⁸⁸ The consensus broke down over the question of the appropriate regulatory solution. Here strong and weak contractarians differentiated themselves. The strong contractarians, like Easterbrook and Fischel, having acknowledged a contract failure, could not make the usual assertion that actors who lay out capital are intrinsically better situated to devise a maximizing term than are judges, legislators or bureaucrats. For a discussion of that argument, see Oliver E. Williamson, *Organization Form, Residual Claimants, and Corporate Control*, 26 J. L. & ECON. 351, 361 n.27 (1983) (government may be at a disadvantage with respect to recognizing organizational innovations). This forced them to propose procedural constraints on the amendment process. But they stopped there. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 5, at 1444. Mandatory prohibition of suspect provisions, they said, should be avoided. It would choke innovation and could not be tailored to particular contracting circumstances. *Id.* at 1445-46. See also Coffee, *No Exit*, *supra* note 85, at 950. Easterbrook and Fischel repeat this position in the book. EASTERBROOK & FISCHEL, *supra* note 4, at 33.

The weak contractarians advocated government intervention in the form of mandatory terms. Government rules can maximize, they said, where the subject matter presents informational complexities and only marginally concerns the particular firm's value. Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1849-50 (1989) (opting-out amendments tend to be optimal where the opting-out concerns wealth transfers from investors to managers; expected benefits from opting-out are largest where the problem varies considerably over time and over cases); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1731 (1989). Cases where managers try to opt-out of the duty of loyalty on a broad-brush basis fit this description.

The appearance of this consensus against universal "opting-out" had paradigmatic implications. The consensus confirmed the legitimacy of legal intervention in corporate affairs from an economic perspective. In other words, corporate law and economics would go forward under the Williamsonian paradigm.⁸⁹ Although no one mentioned it at the time, this also began a process of disassociation between corporate law and economics and the nexus-of-contracts concept of the corporation. The process continues today.

Easterbrook and Fischel joined the mandatory/enabling consensus, albeit with qualifications.⁹⁰ Their book iterates this position.⁹¹ In taking this position they do not, of course, expunge contract from their theory of the firm. They still tell a creation story in which free contract reigns. But, since contract turns out to be a matter of degree, the issue goes to the dimensions of the zone of contract freedom provided for by a particular model. Easterbrook and Fischel's zone is rhetorically expansive, but more compact as a practical matter. A blank contracting slate occurs only in respect to recent and prospective initial public offerings. Since most Fortune 500 companies went public long ago, the critical questions respecting most corporations remain legitimate subject matter for legal mandates.

(b) *Takeovers reversed.*—Takeovers made a contractual picture of the public corporation plausible in the first place. Under the managerialist paradigm of the corporation, managers had unassailable and excessive power. As hostile tender offers proliferated, market actors broke the power of target managers through the simple expedient of purchasing shares. In effect, what was thought unassailable was assailed successfully through the medium of the discrete contract. As discrete contracts came to alter the flow of corporate power, the nexus-of-contracts corporation came into economic and legal theory.⁹²

Furthermore, such broad-brush authorizations cannot be priced accurately, leading to unproductive uncertainty. Coffee, *Mandatory/Enabling*, *supra* note 86, at 1669-70. But as to other, narrowly defined, more "local" matters, government should stay out. Clark, *supra* at 1732.

⁸⁹ See *supra* note 23 and accompanying text.

⁹⁰ This is true at least in the short run. Easterbrook and Fischel insist that in the long run suboptimal charter provisions will create competitive disabilities causing firms to disappear. They would reform the process with a procedural guaranty of approval by supermajority votes over two successive annual meetings. Easterbrook & Fischel, *The Corporate Contract*, *supra* note 5, at 1442-44. They endorse this two-meeting rule again in the book, albeit more hesitantly. EASTERBROOK & FISCHEL, *supra* note 4, at 33.

⁹¹ EASTERBROOK & FISCHEL, *supra* note 4, at 32-34 (the "latecomer term"). Indeed, the book shows that the tendency toward contract failure has intensified in the intervening years. In their tender offer they cite empirical evidence that shareholders often approve "contractual" provisions that immediately reduce the value of their stock, with the amount of the loss directly related to the likelihood of a takeover. *Id.* at 196-97.

⁹² See William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1520-25 (1989).

Fittingly, developments begun in the late 1980s in response to takeovers are prompting the nexus-of-contracts corporation's subsequent departure. Shark repellent charter amendments and poison pill plans—"contractual" modifications that entrench management and devalue the shareholders' investment—retained the support of the courts even as they became more widespread and effective.⁹³ In addition, state legislatures came down emphatically on the side of defending managers. Their antitakeover statutes imposed significant costs on hostile control transfers.⁹⁴ Viewed cumulatively, these changes open up a rift between the contract paradigm's implicit normative structure, on the one hand, and that of actual corporate contracts and state corporate law, on the other.

To their credit, Easterbrook and Fischel not only admit, but explore the negative implications of these developments for the contractual corporation. They conclude that takeover law has developed in an inefficient direction. Managers exploit the collective action problem in getting shareholders to assent to shark repellent provisions. And, in the "last period," when managers defend their jobs from attack, the ordinary controls of the capital and labor markets do not operate. Judicial intervention becomes the only available means to the end of inefficient deployment of assets.⁹⁵

Furthermore, Easterbrook and Fischel abandon the "race to the top" story of state corporate law. This tale had it that a market for charters operated among the states, with the most efficient state getting the most business.⁹⁶ It was first formulated to counter the assertion that the state corporate law system was a corrupt "race for the bottom."⁹⁷ But the "race to the top" assertion was more than a point of critique. It threw the development of state corporate law into an evolutionary context determined by economic competition, thereby fusing positive law

⁹³ The sanction by the Delaware courts of the "poison pill" as a legitimate exercise of business judgment, *see* *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985), caused a shift in the balance of power away from hostile offerors and back to defending managers. *See* Charles M. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54.

⁹⁴ These currently come in three models: Fair price (acquirer must offer same consideration in subsequent merger as in acquisition of control block), asset freeze (prohibition of business combination with acquirer for stated number of years) and control share (voting rights denied to control shares until disinterested shareholders vote to grant them). *See, e.g.*, ARIZ. REV. STAT. ANN. §§ 10-1215, 10-1221(A), 10-1222(3)(a)-(b) (1990) (control share, asset freeze, fair price); CONN. GEN. STAT. ANN. §§ 33-374(e), 33-374c(b) (West 1990) (asset freeze, fair price); DEL. CODE ANN. tit. 8, § 203(b)(5) (1991) (asset freeze, fair price); FLA. STAT. ANN. §§ 607.0901(4)(f), 607.0902(5) (West 1990) (fair price, control share); N.Y. BUS. CORP. LAW §§ 912(b), 912(c)(3)(A) (Consol. 1991) (asset freeze, fair price).

⁹⁵ EASTERBROOK & FISCHEL, *supra* note 4, at 168-70.

⁹⁶ Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

⁹⁷ Specifically, Delaware, acting in complete disregard of the public interest, garnered chartering fees by accommodating the interests of corporate managers. Cary, *supra* note 1.

and contract. Legal mandate was reinterpreted as form; the substance was contract.

Today, Easterbrook and Fischel speak of the performance of state corporate law with less confidence. In their opinion, while survival still is the best measure of success, state corporate law is a process of satisfying rather than optimizing. No one, moreover, knows what the market wants.⁹⁸ Easterbrook and Fischel do find a contractual term to describe the proliferation of antitakeover statutes. In a rare resort to Williamsonian terminology, they ascribe the legislation to management "opportunism."⁹⁹ But this is bravado. Their model no longer fuses state law together with contract so as to make economics the sole determinant of the law's evolution.

C. Summary

The nexus-of-contracts theory provided an excellent focal point for the Easterbrook and Fischel enterprise of ten years ago. It had shock value. It took the obviously mandatory and, with apparent plausibility, called it not merely "voluntary," but "contract." It took a situation of obvious contract failure and, by reference to a little financial economics, called it contract success. All the while it served the purpose of working a reversal of the academic presumption in favor of intensified regulation. But the picture changed around 1988. The difficult questions about the workability of the contractual conception became unavoidable. By 1988, however, Easterbrook and Fischel did not need to avoid them. The regulatory presumption had been reversed, and economic analysis had become everyday business. The insistence on universal free contract could be relaxed in the interest of maintaining the plausibility of the larger enterprise. Meanwhile, in the takeover area, a lawmaking system once extolled as an exemplar of free contract in action acted out a nightmare scenario, at least from the perspective of Easterbrook and Fischel's model. Clearly, the original contract paradigm had outlived its usefulness.

Easterbrook and Fischel have been adroitly stepping away from it ever since. Powerful theoretical foundations and ideological correctness are exciting and gratifying, but academic corporate law leans more to power talk than to theory talk. This power talk need not have immediate legal consequences in order to be plausible as talk. But the talk's plausibility does require that action be at least a possible result. Since action occurs in the world of practice, staying plausible requires staying in close touch with the developments in that world and adjusting the theory accordingly. In *The Economic Structure of Corporate Law*, Easterbrook

⁹⁸ EASTERBROOK & FISCHEL, *supra* note 4, at 218.

⁹⁹ *Id.* at 221-22. To their credit, they refuse to recommend federal legislation or federal preemption by virtue of the existence of the Williams Act. *Id.* at 222-27.

and Fischel make the necessary adjustments.¹⁰⁰

III. GAIN SHARING AND THE PRESUMPTION AGAINST REGULATION

The diminished status of the nexus-of-contracts corporation leaves Easterbrook and Fischel with a conventional mixed model. On the left hand, they work with relational contracts, omitted terms, gap filling, uncontrolled management opportunism, and necessary judicial intervention. On the right hand, they rely on their creation story, stock market pricing of contract risk, and the presumption against regulation. The very structure of the mix is Williamsonian—hierarchies on the left, markets on the right.¹⁰¹ *The Economic Structure of Corporate Law* shows us how Easterbrook and Fischel mediate between the two. Predictably, they keep double gestures to a minimum and privilege the right hand to the greatest possible extent. This skews their mixed model in the direction of minimal regulation. They thereby retain a distinct profile, staying on the market side of the mainstream even as they adhere to the consensus view of the impossibility of contractual corporate governance.

Two assertions help keep Easterbrook and Fischel's profile distinct. The first is that the norm of shareholder "expectations" that operates in corporate law should draw its content from first generation financial economic models. The second is the presumption against regulation. Easterbrook and Fischel combine the two to take a controversial position about legal rules that allocate shares of gain in respect of corporate control transfers, mergers, and takeovers.

There follow some critical questions about Easterbrook and Fischel's position on gain sharing and their presumption against regulation.

A. Gain Sharing

Easterbrook and Fischel take up judicial gain-sharing rules¹⁰² as applied or suggested for application on three fact patterns—transfers of controlling blocks of stock at a premium over market, investments in corporate opportunities by managers or majority shareholders, and cash-out mergers.¹⁰³ They model a paradigm transaction in each category and

¹⁰⁰ These adjustments are made in a minimalist fashion. They stop short, for example, of acknowledging that the old Berle and Means theory of separation of ownership and control has returned to the fore because their market control story had failed to play out in practice.

¹⁰¹ See generally OLIVER WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTI-TRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION* (1975).

¹⁰² "Gain sharing" in this context concerns transactions initiated by a shareholder controlling or in the course of acquiring control of a corporation that, viewed substantively rather than formally and over the long term, yield a higher return to the controlling shareholder than to the corporation's other shareholders. "Gain-sharing rules" are applications of corporate fiduciary law that modify the formal result with the purpose of pro rata distribution of the transactional gain among the entire class of shareholders.

¹⁰³ EASTERBROOK & FISCHEL, *supra* note 4, at 126-44.

run a comparative analysis. Each transaction is value-maximizing: the transferee of the control block, the taker of the corporate opportunity, and the surviving parent in the cash-out merger each makes an investment for maximum return.¹⁰⁴ In each case, both the investment and the resulting gains are for the account of a controlling party: the selling and purchasing majority shareholders in the control transfer, the parent corporation in the cash-out merger, and the majority shareholder or officer in the corporate opportunity case. Finally, in each case, the gains are not shared with the other equity investors in the subject corporation.

Easterbrook and Fischel base their case against gain sharing on a financial economic theory of shareholder expectations. Given market trading, equity investors, looking *ex ante*, will prefer maximum aggregate gain. An unregulated environment assures this. At the same time, having to forego gain in a particular case does not amount to a cognizable shareholder injury. Since a diversified shareholder ends up on the winning side as well as the losing side in the long run, the investor prefers a legal rule that promotes the largest aggregate amount of investment gain,¹⁰⁵ at least so long as each transaction leaves each investor's *ex ante* holding unimpaired.¹⁰⁶ Sharing rules discourage gain-creating transactions, thus they should be discouraged. The presumption against regulation also comes to bear. Courts see only the gains, never the *ex ante* possibility of loss. They cannot recreate the risk-discounted projections that determine the defendant's conduct at the time it invests in the suspect transaction. They therefore have no basis for allocating gains between risk-bearing and nonrisk-bearing parties.¹⁰⁷

Easterbrook and Fischel extend this analysis to takeover defense fact patterns. They advocate a passivity norm for managers facing hostile offers, even though management might garner a greater share of transactional gain for the target shareholders by initiating an auction.¹⁰⁸ They dislike fiduciary rules leading to auctions because, like fiduciary constraints of control transactions, they admit an *ex post* perspective that disrupts the economics of an earlier act of investment.¹⁰⁹ Once again they assert that rules assuring shared gain will result in lower aggregate

¹⁰⁴ EASTERBROOK & FISCHEL, *supra* note 4, at 112-16.

¹⁰⁵ *Id.* at 120-24.

¹⁰⁶ *Id.* at 124-25. One wonders whether a Kaldor-Hicks optimality norm could be substituted with the right showing.

¹⁰⁷ *Id.* at 117.

¹⁰⁸ This is a longstanding position. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Frank H. Easterbrook & Gregg A. Jarrel, *Do Targets Gain From Defeating Tender Offers?* 59 N.Y.U. L. REV. 277 (1984). For the other side of the issue, see Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

¹⁰⁹ EASTERBROOK & FISCHEL, *supra* note 4, at 185-90.

gains and injure shareholders.¹¹⁰

This line of analysis has attracted a great deal of attention.¹¹¹ The particulars of these debates will not be iterated here. We take up Easterbrook and Fischel's position on gain sharing for a limited purpose. It gives us a look at Easterbrook and Fischel as they prescribe the root and branch reconstruction of an area of corporate law. This contrarian deregulatory position impairs their broader claim to consonance with existing law.¹¹² Their theory gets out of touch with the practice, and loses

¹¹⁰ *Id.* at 188-89.

¹¹¹ Articles on the takeover defense problem are legion. For a sample, see those cited *supra* note 108.

Easterbrook and Fischel's position respecting sales of control, cash-out mergers, and corporate opportunities was set out in an early article, Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705-37 (1982). The power and novelty of the article's challenge to fairness inquiries caused it to become very well known. Some of the responsive commentary is cited *infra* note 112.

¹¹² Nor have Easterbrook and Fischel been strictly accurate in their characterization of their scholarly opposition. Their attack on gain-sharing rules in sale of control situations was addressed to a large body of commentary advocating an equal sharing rule. Andrews suggested this rule. William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505, 515-17 (1965). In their original commentary on this subject, Easterbrook and Fischel dismissed this approach as an antimanageial proposition advocated without regard for the economics at stake. In *Corporate Control Transactions*, *supra* note 111, at 703, Easterbrook and Fischel describe the argument for equal sharing as follows: "[F]iduciary principles require fair conduct; equal treatment is fair conduct; hence, fiduciary principles require equal treatment." This is not an accurate characterization of the argument.

The equal sharing proposition grew out of a positive inquiry undertaken in a cognizably contractual conceptual framework, with wealth-maximization clearly stated as the ultimate objective. The question was whether control transactions caused injury to noncontrolling shareholder interests. See Andrews, *supra* at 516-19, 521-22; Victor Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 296-99 (1966). "Equal sharing" supposedly prevented possible injury and thus protected expectations of management responsibility. Brudney took the position that the sale of control at a premium should be permitted only upon a showing of informed consent of the other shareholders. *Id.* at 297. These commentators recognized the possibility that the rule might in some cases inhibit control transfers motivated by the opportunity for improved management. Andrews, *supra* at 519; Brudney, *supra* at 297-98. Andrews thought such injury unlikely to occur. Andrews, *supra* at 519.

The discussion went on into the 1980s. Hamilton asserted that injury to noncontrolling shareholders is a cognizable possibility, particularly with respect to small, unlisted companies. Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248, 256-59 (1985). Levmore, who does not advocate an equal opportunity rule, nevertheless holds open the shareholder injury question, stating the issue to be whether the legal system may assume that the new controlling party brings beneficial innovation to the firm, or whether the system should make specific inquiries as to the particular plans of the controlling party. Saul X. Levmore, *A Primer on the Sale of Corporate Control*, 65 TEX. L. REV. 1061, 1064, 1067 (1987) (reviewing DAVID C. BAYNE, *THE PHILOSOPHY OF CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY* (1986)).

Of course, some of the sale of control commentary did fall into the antimanageialist mold and lack a basis in the economics of shareholding. Jennings's analysis, for example, makes a connection between control power and fiduciary responsibility and stops there. Jennings reasons that sales of control should be regulated because the control "in equity" belongs to others. Richard W. Jennings, *Trading in Corporate Control*, 44 CAL. L. REV. 1, 29-31 (1956). See also David C. Bayne, *A Philoso-*

some of its coherence.

Easterbrook and Fischel admit that the law of takeover defense does not conform to their model.¹¹³ Gain sharing is what the great Delaware tender offer cases of the last decade are all about.¹¹⁴ But Easterbrook and Fischel do claim that a more congenial "laissez faire"¹¹⁵ regime applies to control transfers, cash-out mergers, and corporate opportunities. This claim does not prove out, however. It is true that the two famous cases that move in the direction of a sharing rule for control transfers—*Perlman v. Feldmann*¹¹⁶ and *Jones v. H.F. Ahmanson & Co.*¹¹⁷—sit quietly by themselves in the reporters. The cases' invitations to a gain-sharing constraint have not been accepted, but they seem to remain "good law" in their narrow spheres. As such, they still constrain the parties who plan these transactions.¹¹⁸ As to corporate opportunities, it is not safe to say, as Easterbrook and Fischel do, that "a parent corporation may allocate a business opportunity to itself . . . even though public shareholders in a subsidiary believe that it is unfair."¹¹⁹ On cash-out mergers, Easterbrook and Fischel report that under *Weinberger v. UOP, Inc.*¹²⁰ the appraisal remedy, which offers no gain sharing, is exclusive absent a showing of fraud or misrepresentation.¹²¹ Although this is literally correct, Easterbrook and Fischel fail to point out that the *Weinberger* fraud rule includes an "entire fairness" standard,¹²² and that the fairness standard is read to impose procedural constraints on the cash-

phy of Corporate Control, 112 U. PA. L. REV. 22, 34 (1963) (control party as strict trustee; control cannot be appropriated for personal benefit as it belongs to the corporation). Berle argued for the duty almost solely on a policy basis. Adolph A. Berle, "Control" in *Corporate Law*, 58 COLUM. L. REV. 1212 (1958). Berle thought control transfers needed to be regulated less because there was something unfair about the result than because corporate control was important as an economic and social fact, *id.* at 1212, requiring standards of responsibility for its exercise. *Id.* at 1224.

¹¹³ EASTERBROOK & FISCHEL, *supra* note 4, at 209.

¹¹⁴ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989); *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

¹¹⁵ EASTERBROOK & FISCHEL, *supra* note 4, at 110.

¹¹⁶ 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

¹¹⁷ 460 P.2d 464 (Cal. 1969).

¹¹⁸ For a transaction drafted to avoid possible control transfer liability, see the facts of *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1100*03 (Del. 1985).

¹¹⁹ EASTERBROOK & FISCHEL, *supra* note 4, at 140 (citing *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883 (Del. 1970); *Myerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967)). *But cf.* *David J. Greene & Co. v. Dunhill Int'l, Inc.*, 249 A.2d 427 (Del. 1968) (minority shareholder of subsidiary had cause of action against parent/majority holder for purloining corporate opportunity which rightfully belonged to subsidiary).

Nor, so far as concerns corporate opportunities taken by officers and directors, is it all clear that a salary reduction follows as a give back. See EASTERBROOK & FISCHEL, *supra* note 4, at 115, 141-42.

¹²⁰ 457 A.2d 701 (Del. 1983).

¹²¹ EASTERBROOK & FISCHEL, *supra* note 4, at 158-59.

¹²² *Weinberger v. UOP, Inc.*, 457 A.2d 701, 703 (Del. 1983).

out merger's accomplishment.¹²³ These "fair" procedures, in turn, create an opportunity to negotiate a share of the merger gain for the minority shareholders of the subsidiary.¹²⁴ The *Weinberger* court does not decree a "fair share" of the merger gain. But it does scrutinize merger procedures against the normative yardstick of the everyday arm's-length exchange in hopes that some part of the gain will find its way to the minority.¹²⁵

The law here does not decree fair shares of transactional gain. But continuing concerns about gain and sharing exercise a strong influence on its development. The courts mediate between the positive consequence of encouraging investment and the negative consequence of permitting the corporate form to be used as a vehicle for the conversion of returns on capital invested by others. Results are mixed and context sensitive. Corporate control transfers are permitted subject to an open-ended injury rule. Corporate opportunities are treated under regular fiduciary rules—that is, they are prohibited subject to the possibility of a waiver if procedural requirements are met. The cash-out merger cases chart a course between permission and prohibition. They seek to improve the position of minority shareholders while avoiding direct judicial "pie-slicing." In so doing they draw on the normative framework of contract law. In contract, the parties set the consideration while the court monitors the relational framework in which they operate. The cash-out merger, like the latecomer "opting-out" situation, does not go forward in a viable framework for contracting. The control of the investing party deprives other parties of freedom of choice. Judicial scrutiny of procedures results.

Fiduciary law in the takeover area takes a similar normative perspective. By imagining the corporation as a contracting party selling a bundle of assets¹²⁶ and applying basic contract norms, one can easily defend management defensive maneuvers as means to the end of a higher price.

In sum, two series of choices determine the structure of the law in these situations. The first is a positive choice to model the corporation as an entity, followed by a choice to place the entity in the normative frame-

¹²³ *Id.* at 703, 708-10.

¹²⁴ *Id.* at 709 n.7. The special negotiating committee is the procedural device. Whether its employment will result in a plausible reconstruction of the negotiations that precede an arm's-length merger is far from clear. See *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985).

¹²⁵ *Weinberger*, 457 A.2d at 708-15. To the extent that a problem arises because of opportunistic plaintiffs who wait for the risk-bearers to produce the gain and then sue, it can be dealt with by limiting opportunities for suit long after the fact.

¹²⁶ See Lucian A. Bebchuk, *The Sole Owner Standard For Takeover Policy*, 17 J. LEGAL STUD. 197 (1988). In this paper, Professor Bebchuk supports a "sole owner" standard for corporate acquisitions. Under this standard, a corporation should be acquired if and only if the shareholders deem the offered acquisition price to be higher than the value of the corporation's assets. Accordingly, one subscribing to Professor Bebchuk's theory would view the corporation as selling a bundle of assets.

work of contract law. Easterbrook and Fischel argue for two different choices. Under the first, the picture of a corporate entity is dissolved, and a positive picture limited to market holdings is substituted. Then the disaggregated holdings are placed in a normative framework that is contractual, but drawn from financial economics rather than contract law. In making these choices, Easterbrook and Fischel push their theoretical insistence on absolute subordination of the "corporate entity" to a place where neither law, nor apparently, the mainstream economics of law¹²⁷ seems inclined to follow.

Will this version of a rational legal regime prove out in the long term? The scenario seems improbable. To abandon the model of the contracting corporate entity is to accord absolute normative primacy to the market price of the stock. Easterbrook and Fischel argue that this should be done, even though the market price cannot be assumed to be efficient in a fundamental value sense. In their view, three assumptions are safe: first of all, prices change quickly in response to new information; second, price changes are unbiased in that they do not systematically overshoot or undershoot intrinsic value as determined over time; and third, the degree to which price changes reflect underlying economic reality does not change substantially during short periods.

These assumptions are not safe, however. The second and third have been undermined by contrarian market economists. These economists are recasting the essence of Keynes' famous "beauty contest" metaphor¹²⁸ in a deterministic model¹²⁹ of stock market pricing. Under this "noise trading" approach,¹³⁰ quick price changes are not unbiased. Supporting studies show that, contrary to Easterbrook and Fischel's assumptions, stock prices *do* overreact to changes in fundamentals.¹³¹ Moreover, investors chase trends, thereby causing aggregate shifts in de-

¹²⁷ Corporate entities have a place in the Williamsonian paradigm as "governance structures." See OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 294-97 (1985).

¹²⁸ JOHN M. KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY* 154-56 (1936). With his "beauty contest" metaphor, Keynes likens professional investment to newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole. Likewise, an investor is not concerned with what an investment is worth to the man who buys "for keeps," but rather with how the market will influence the investment's value.

¹²⁹ See WILLIAM J. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 51-53 (1965).

¹³⁰ See, e.g., Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. ECON. PERSP., Spring 1990, at 19; Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591 (1986). Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992), provides an excellent discussion of this theory's bearing on legal questions.

¹³¹ See David M. Cutler et al., *What Moves Stock Prices?*, J. PORTFOLIO MGMT., Spring 1989, at 4.

mand.¹³² Finally, contrary to Easterbrook and Fischel's assumptions, the degree to which prices reflect underlying economic reality can shift abruptly during short periods. The Crash of 1987 starkly demonstrated this.¹³³ *Ex post* analyses of the Crash look to illiquidity, undisclosed hedging strategies, and information differentials for explanations.¹³⁴ These analyses confirm that changes in fundamental value factors were not the primary causes of the Dow's drop.

It becomes increasingly less plausible to model the legal shareholder as the passive holder of a diversified portfolio of fifteen stocks. Given the assertions of the noise trading theorists, the reliance on market pricing implicit in this model does not impress one with its "reasonableness." Today's reasonable shareholder should look at market pricing as a complex and volatile process that reflects fundamental value but remains subject to extraneous forces of supply and demand. This, of course, assumes that a unitary and simple "reasonable investor" can be modeled at all. Given the range of objectives among real world investors, their varying time horizons, the array of trading strategies they follow, and their volatile sentimental dispositions, one could argue that the law should not make the attempt. Easterbrook and Fischel contend not only that the attempt should be made, but that it can succeed easily by reference to the efficient market hypothesis and the capital asset pricing model. This is a plausible position. But given the complex and unsettled nature of the economics, their "reasonable investor" should be viewed as a problematic normative proposition. No empirical showing makes this model of the investor a matter of positive imperative.

It should be noted that reference to noise trading theory and its realistic picture of the determinants of market prices does not by itself resolve the issue in favor of gain-sharing rules. It merely undermines some assumptions supporting Easterbrook and Fischel's case against them. Noise trading theory offers only indirect support for the conclusion that investors view particular investment vehicles as entities and expect pro rata shares of gain on invested capital. To strengthen further, if not conclude, the case for gain sharing, one must bring the economic rationality of the law to bear against Easterbrook and Fischel's deregulatory assertions.

As the foregoing discussion indicates, *ex post* concerns respecting

¹³² Shleifer & Summers, *supra* note 130, at 23-26.

¹³³ In early October 1987, the Dow Jones average was at the 2600 level. Then, on October 19, the average fell by more than 500 points on unprecedented trading volume. Before the end of the month, the Dow was trading at under 1800—a drop of about a third during the course of the month. Unsympathetic economists took the occasion to pronounce the death of the efficient market hypothesis. See Bruce I. Jacobs & Kenneth N. Levy, *The Complexity of the Stock Market*, J. PORTFOLIO MGMT., Fall 1989, at 19, 22.

¹³⁴ See Michael J. Brennan & Eduardo S. Schwartz, *Portfolio Insurance and Financial Market Equilibrium*, 62 J. BUS. 455 (1989); Gerald Gennotte & Hayne Leland, *Market Liquidity, Hedging and Crashes*, 80 AM. ECON. REV. 999 (1990).

corporate allocational problems survive in the law despite the sustained pressure of Easterbrook and Fischel's *ex ante* microeconomic model. This treatment has an implicit economic rationality. The law, making an astute economic judgment, declines to attach itself to any single model of asset valuation.¹³⁵ It falls back on a safe assumption—that investors look both at market returns and at company-specific returns. The decision to be open-ended about valuation having been made, intervention toward the end of gain sharing follows from the application of basic fiduciary and contractual norms. Again, there is an implicit economic rationality: we achieve our level of wealth by integrating with one another rather than operating independently as autonomous, self-sufficient actors. The legal norms recognize the necessity of cooperation and serve as a facilitating mechanism. They preserve the incentive to cooperate in situations where private ordering inadequately protects against abuses of discretion by those entrusted with assets.¹³⁶ The persistence of sharing rules reflects a judgment that control transfers, cash-out mergers, and takeovers should be viewed in the context of a larger system of cooperative investment and production.

Finally, it should be noted that the law never loses touch with political and social concerns as it pursues the goal of economic welfare. It therefore holds open the possibility that an economically rational result might have to be qualified. In legal contexts, for example, the normative habit is to admit a more complex model of the person, even an actor in a business role, than the rational economic actor employed by Easterbrook and Fischel. Once the model of the person is opened up, the normative dynamic changes. Identity can count along with material satisfaction. A less precise welfare calculation based on a complex behavioral model can compete with a more precise calculation grounded in the economic self-interest model. And, finally, *ex post* problems of unreciprocal treatment can compete with *ex ante* welfare calculations.

B. The Presumption Against Regulation

Easterbrook and Fischel's treatment of gain-sharing rules draws heavily on the presumption against regulation. The presumption's operation on judicial fiduciary rules bears scrutiny at this point. Once inspected, the presumption loses much of its force.

Easterbrook and Fischel begin their analysis on safe ground. Mar-

¹³⁵ In so doing it follows the economics. There is no generally accepted theory determining the right price for any asset. See Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U. L. REV. 761, 771-72 (1985).

¹³⁶ Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 802 (1983); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 4 (1975). See also Alison G. Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 747-48 (1978) (the trend in recent years has been one of ever-increasing demands for regulation in areas such as the behavior of corporate management in order to deter cheating and achieve fairness).

ket constraints operate on corporate actors, but these constraints are not perfect. Therefore, courts sometimes are the cheapest source of regulation. However, the appropriate field of judicial intervention is narrow. It is limited to a small core of situations in which *ex ante* contracting is too expensive.¹³⁷

Then the presumption comes to bear and they draw a line. Fiduciary constraint is cost effective only as to the basic fact patterns covered by the duties of loyalty and care—one shot self-dealing and hopeless incompetence.¹³⁸ In other situations:

Costs of decision *ex post* will be highest precisely when it [is] also most difficult to contract *ex ante*. So when claims are made on the basis of the fiduciary principle—as opposed to a specific contract—courts are likely to lack the essential tools of decision. This means that *ex post* settling up in markets has a comparative advantage over courts at enforcing the fiduciary principle¹³⁹

They go on to argue that the line should be drawn with special emphasis in respect to control transactions. In these cases, opening the door to judicial intervention will lead to indeterminate and costly rules and will stir up litigants in pursuit of bigger shares of gain.¹⁴⁰ They relax the line only on the takeover fact pattern. There they admit that *ex post* market constraints do not operate and judges are the only recourse against managerial misbehavior.¹⁴¹

There are at least two problems with the line Easterbrook and Fischel draw. First, it is not clear that effective *ex post* settling up can be assumed. If the complaints of today's institutional investor activists count as evidence,¹⁴² *ex post* settling up is more an analytical construct than a real world phenomenon. When, given a going concern, do we arrive at the *ex post* position and extract our givebacks from ineffective and self-serving managers? The same information problems that make shareholder action ineffective *ex ante* would seem to recur on a continuing basis, becoming a cost barrier to *ex post* settling up. Absent a takeover, *ex post* settling up may occur in one of those infinitely long runs.

Second, it is not clear that a material cost burden is presented by judicial intervention under fiduciary rules. Rules that make judicial intervention possible do not make litigation inevitable in every contract relationship. Intervention in contract relationships under the fiduciary rubric occurs interstitially. In fact, a recent study indicates that large American corporations only rarely experience derivative actions.¹⁴³ Ju-

¹³⁷ EASTERBROOK & FISCHEL, *supra* note 4, at 98-99. The result is the so-called "business judgment" rule.

¹³⁸ *Id.* at 99.

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 119. See also *id.* at 240 (indeterminacy).

¹⁴¹ *Id.* at 168-70.

¹⁴² See *supra* note 14.

¹⁴³ Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J.L. ECON. & OR-

dicial rules have their principal effect *ex ante*. They channel the terms of future relational contracts, serving to discourage questionable behavior before it occurs. Indeed, rules that are not themselves optimal as contract terms can cause optimal contracting by forcing actors to contract around them.¹⁴⁴ Furthermore, it is basic to corporate law that this intervention only occurs where, for cost or structural reasons, corporate actors cannot effectively create their own contract terms. By hypothesis, then, judicial intervention works as an integral, even necessary, part of the evolutionary process by which actors create optimal governance terms.

A volitional point about litigation costs should also be noted. Given expensive relationships and exhaustive lawyering, the key moment respecting cost occurs when the lawyer and corporate actor meet to appraise the liability consequences of prospective courses of action. The process itself is costly, of course, and the indeterminacy of legal rules makes it even more costly. But, at least in the corporate area, legal professionals bring remarkable adaptative skills to bear in keeping these costs under control. And, significantly, the precise amount of cost incurred rests in the first instance on choices the potential defendant makes at the planning stage.

Today, a stronger case can be made for stepped-up fiduciary regulation and against the presumption against regulation than at any time in the last decade. The failure of market mechanisms to control management conduct adequately once more is widely acknowledged.¹⁴⁵ Curiously, current discussions remain in a deregulatory mode. The participants look to institutional investor self-help¹⁴⁶ and pass over the prospect of less costly legal regulation.

A decade of contractual thinking about corporate law leaves us with the tools to create statutes and judicial rules that regulate corporate conduct, while still leaving open paths for contractual innovation within particular corporations. Corporate fiduciary law has always had a tentative, experimental pattern of application,¹⁴⁷ and today it can even have a conditional pattern. The enactment of corporate laws subject to "opting-out" in particular corporations by shareholder vote is now everyday busi-

GANIZATION 55, 58-60, 84 (1991) (concluding that derivative actions are infrequent, and an ineffective governance tool).

¹⁴⁴ See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

¹⁴⁵ See the articles cited *supra* notes 14-17.

¹⁴⁶ See Black, *supra* note 16, at 570-91, 608 (model of shareholders' incentives to sponsor a voting proposal suggests that when economies of scale are strong, institutional investors have an incentive to take an active role in corporate management); Gilson & Kraakman, *supra* note 15 (privately sponsored core of independent directors to monitor management performance on behalf of shareholders).

¹⁴⁷ See William W. Bratton, *Welfare, Good Will and Corporate Fiduciary Law* (July, 1992) (unpublished manuscript, on file with the author).

ness.¹⁴⁸ It is the contract paradigm's contribution to the exercise of regulation. Unfortunately, heretofore the device has been used to make management-protective innovation tolerable. It would be better used in the service of a more exacting legal model of management conduct. The regulatory improvements pursued piecemeal by today's institutional investor activists¹⁴⁹ also can be pursued as law reform suggestions under the fiduciary rubric. Liberal use of the opting-out device can minimize the risks concomitant with such regulatory experiments and put the burden of justification on management, where the perspectives both of traditional corporate doctrine and, it seems, today's institutional activists, would place it.

Easterbrook and Fischel also play at opting-in and -out, but from the opposite point of view. When a problem proves so complex that no clear cut and efficient solution presents itself, they tend to suggest that no positive law solution be imposed. Rather a door should be left open to actors in particular corporations to opt-in to their own regulations.¹⁵⁰ But one can just as plausibly shift the burden, taking an opt-out rather than opt-in approach. This shift follows from the consensus reached in the mandatory/enabling discussion—that contract failure prevails in the governance of large American corporations.

IV. CORPORATE LAW AS MEDIATION

A. *Corporate Politics and Corporate Entities*

Easterbrook and Fischel's economic theory reconstructs the law in one further respect. The primary purpose of their nexus-of-contracts conception of the corporation, as previously noted,¹⁵¹ is to rebut the idea that the law meaningfully establishes producing organizations as "entities." The insight behind this assertion is that the legal corporate entity

¹⁴⁸ The most dramatic and widespread legislative movement toward opting-out concerns the duty of care. See DEL. CODE ANN. tit. 8, § 102(b)(7) (1991). By now at least thirty-five states have followed. For a list of citations, see Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 381 n.30 (1989).

Opting-out shows up in other venues as well. The device is widely used in state tender offer defense statutes, presumably as a part of a strategy to bolster the statute's constitutionality. Typically, the board gets a stated number of days after the statute's effectiveness to resolve not to be governed. See DEL. CODE ANN. tit. 8, § 203(b)(2) (1991). Opt-out provisions appear in all three of the current models of takeover statutes. See *supra* note 94.

¹⁴⁹ These include secret ballots, independent director majorities on compensation committees, constraints on golden parachutes, Leslie Wayne, *Seeking to Stay Out of Proxy Battles*, N.Y. TIMES, Apr. 8, 1991, at D1, and limits on compensation schemes lacking ties to corporate performance. See Gilson & Kraakman, *supra* note 15, at 891 (citing Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990)) (low correlation between the compensation of managers and the economic performance of their companies).

¹⁵⁰ See EASTERBROOK & FISCHEL, *supra* note 14, at 263 (insider trading).

¹⁵¹ See *supra* text accompanying note 84.

is a reification, while transactions are events and therefore real. A defensible positive theory takes account of real phenomena.

This is an attractive point of view. Entity theories tend to be opaque and can distract attention from economic matters. They also have disturbing political implications. They attach larger, organic values to the organization, values that take precedence over individual liberty.¹⁵² But, despite this inconvenience, the "organization" remains central to our experience of corporations. Corporate entities, therefore, continue to show up in corporate law, carrying normative content and playing apparently decisive roles.¹⁵³ A theoretical choice results. One can either attribute the entity's persistence to false consciousness and disregard it on the assumption that economic rationality takes care of the problem in the long run, or try to explain its persistence in economically and politically acceptable terms.

The latter choice is worth exploring, but a methodological adjustment has to be made first. Economists assume that reality is comprised exclusively of the intentional actions of human actors.¹⁵⁴ This limiting assumption must be relaxed if we are to explain legal corporate entities. Reference to social theory¹⁵⁵ quickly assures us that this can be done safely.

Contemporary social theory offers useful descriptions of corporate organizations which can be layered to produce a rich articulation of the entity concept's appearances in the law. Sometimes the "entity" shows up performing the functions ascribed to it in economic theory—that is, it works as a form that facilitates collective economic action, or as a mode of description for a sequence of transactions or an aggregation of capital.¹⁵⁶ At other times, the law refers to the entity because it conceives of the corporation as a purposive organization,¹⁵⁷ and imposes a duty on corporate actors to respect that purpose. Thus, historically, the duty of loyalty is owed to the entity, not the shareholders. It is at this layer that the entity begins to take on normative content.

¹⁵² These values, therefore, historically have not fared well in American legal theory. See Bratton, *supra* note 92, at 1511-13.

¹⁵³ See *infra* text accompanying notes 126-27.

¹⁵⁴ See Gunther Teubner, *How the Law Thinks: Toward a Constructivist Epistemology of Law*, 23 LAW & SOC'Y REV. 727, 730 (1989) (dismissing this methodological individualism as a "naïve reality assumption").

¹⁵⁵ In particular, the systems theory of Niklas Luhmann. See generally GUNTHER TEUBNER, *AUTOPOETIC LAW: A NEW APPROACH TO LAW AND SOCIETY* (1988). For an excellent review of the book, see Arthur J. Jacobson, *Autopoietic Law: The New Science of Niklas Luhmann*, 87 MICH. L. REV. 1647 (1989).

¹⁵⁶ That is, the limited functions allowed the legal entity within the parameters of economic theory. See *supra* note 83.

¹⁵⁷ Cf. TALCOTT PARSONS, *STRUCTURE AND PROCESS IN MODERN SOCIETY* 16-17, 63 (1960). The term "organization" refers to a broad type of collectivity, an example of which is a business firm. The defining characteristic of the organization is the attainment of a specific goal or purpose. The organization is the mechanism by which that goal is implemented.

The legal entity must be given still more normative content if we are to explain its persistence in the teeth of Easterbrook and Fischel's powerful economic critique. At this point, reference can be made to the work of Professor Gunther Teubner. Teubner, drawing on the systems theory of Niklaus Luhmann, demonstrates that organizations are, in fact, epistemic subjects. He locates the "organization" not in the individuals, but in their communications. Through internal communications and decisions, he argues, organizations construct social realities of their own. They develop a capacity for collective action "by communicatively constituting their identity" and going on to act.¹⁵⁸ The corporate entity takes on social reality because its collective actions are oriented around its self-description.¹⁵⁹ As the entity takes on social reality, lawmakers respond protectively out of respect for the identities of the participating individuals.

Teubner's theory of the firm has explanatory power. This can be illustrated by reference to some leading recent developments in corporate case and statutory law: the *Revlon*¹⁶⁰ and *Time*¹⁶¹ cases, antitakeover statutes,¹⁶² and constituency statutes.¹⁶³ *Revlon*, as is well known, imposes a duty to auction control of the corporation for the short-term benefit of the shareholders.¹⁶⁴ As originally articulated, this auction duty attached because, on the facts of the case, "it became apparent to all that the break-up of the company was inevitable."¹⁶⁵ Under that presumption, the board "no longer faced threats to corporate policy and effectiveness."¹⁶⁶ In other words, the board had abandoned protection of the existing organization and could no longer justify its actions by reference to the protection of the economic and social reality contained therein.

¹⁵⁸ Teubner, *supra* note 154, at 728-29. For a more extended treatment, see also Gunther Teubner, *Enterprise Corporatism: New Industrial Policy and "Essence" of the Legal Person*, 36 AM. J. COMP. L. 130, 137-38 (1988) (emphasis in original):

The emergent quality of the "corporate actor" arises from self-description in the action system itself. It is reflexive communication in the action system, communication on its own identity and its capacity for action, that constitutes the corporate actor or the collectivity as a mere semantic artifact, as a linguistically condensed perception of group identity. It is only to the extent that such a corporate actor becomes insitutionalized, i.e., that organizational actors are actually oriented round this self-description, that the corporate actor takes on social reality.

¹⁵⁹ Teubner, *supra* note 158, at 137-38. Teubner's firm is more aptly described as a "network" than an "entity." He calls his approach "enterprise corporatism" and locates its rationality potential in terms of increased learning and higher levels of ability to communicate and process information in response to the two great concerns of risk and uncertainty. I owe this characterization to Joe McCahery.

¹⁶⁰ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

¹⁶¹ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

¹⁶² See *supra* note 94.

¹⁶³ See, e.g., N.Y. BUS. CORP. LAW § 717(b) (McKinney 1991). For commentary, see David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991).

¹⁶⁴ *Revlon*, 506 A.2d at 182.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

As a result, the shareholder maximization norm, subordinated to entity protection by every takeover defense case since *Cheff v. Mathes*,¹⁶⁷ finally came to the fore.

Some commentators and lawyers took *Revlon* to instantiate a shareholder choice norm. Under this reading of the case, the auction duty was triggered by the occurrence of any control transfer.¹⁶⁸ From this perspective, *Revlon* brought the framework of economic agency theory to the law of takeover defense. But, as *Time* later showed, nothing could have been further from the case. The auction duty is triggered by abandonment of the "entity" and the values associated with it. Furthermore, protection of these values also helps explain the rapid proliferation of antitakeover and constituency statutes.

Admitting the entity into the discussion of takeover defense effectively admits distributive politics into the description of corporate law. Easterbrook and Fischel's economic theory, in contrast, draws a hard line against distributive concerns. They do not, however, take the position that such politics do not or should not proceed. They simply remit the process to a venue outside of corporate law. They note, fairly enough, that an economic theory should work singularly toward welfare maximization, leaving distribution to a subsequent analytically separate process.¹⁶⁹ But this normative clarity sometimes comes at the cost of inadequate description. For example, Easterbrook and Fischel account for state antitakeover statutes in terms of "opportunistic behavior by corporate managers."¹⁷⁰ This is a "stab-in-the-back" account that recognizes only the contractual, dark side of a complex politics. Antitakeover legislation did not sweep the country solely because an organized managerial pressure group exploited the cupidity of corrupt politicians. Management certainly promoted the legislation out of self-interest. But the legislation they promoted was politically expedient because it instantiated values of consequence and accorded with a plausible maximization story. The combination of factors caused it to become ubiquitous. If the legislation ought to be repealed, then surely the most effective political strategy confronts the values that legitimized the legislation in the first place. The issue thus joined is one of mixed politics and economics: whether the economic benefits of repeal outweigh the perceived costs of disrupting existing corporate institutions. Unless the politics are admitted, legal theory is disabled from addressing the issue.

Readmitting politics and "entities" into corporate legal theory implies no normative commitment to the primacy of management autonomy. Nor does it necessarily serve as a conceptual entering wedge for

¹⁶⁷ 199 A.2d 548 (Del. 1964).

¹⁶⁸ See Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990).

¹⁶⁹ EASTERBROOK & FISCHEL, *supra* note 4, at 37-38.

¹⁷⁰ *Id.* at 221-22.

the justification of an industrial policy or some other corporatist program.¹⁷¹ The immediate purpose would be the same as that of *The Economic Structure of Corporate Law*, which is to explain a present legal system. The difference would lie in the description's normative implications. Under the economic paradigm, corporate law does one thing—it serves as an instrument for the achievement of maximum wealth. With a thicker description, this functionalist constraint relaxes, while normative instability and conflict come in to the picture. One is invited to conceive of the law as a mediative agency as well as a welfare-enhancing one.

B. *The Mediative Structure of Corporate Law*

Legal theorists and legal decisionmakers deal with the same corporations, but they approach them differently. The theorists aspire to provide objective answers to all questions. Their theories tend to pose clear-cut, determinant choices among alternatives. Legal decisionmakers share the theorists' aspirations. But, in the world of cases and legal practice, the subject matter of legal debates never seems to be determined once and for all by reference to an objective theory or a metaethical scheme. Though legal decisionmakers aspire to theoretical certitude and consistency, in the end they tend to mediate between the alternatives. Accurate descriptions of legal doctrine take cognizance of its mediative aspect.

In practice, corporations are complexes of diverse elements that resist reduction into the neat rationalized blueprints of legal and economic theory. They have a complex of foundations. They are welfarist instruments. They also are nexuses of interpersonal relationships with ethical implications. They advance each participant's self-interest. But they also demand individual sacrifices to collective goals. They are nexuses of contract relationships. At the same time they are self-referential systems—separate entities with identifiable, albeit reified, contents. They include relational contracts and discrete contracts. They result from free contract and yet entail empowerment and dependence. They amount to hierarchical power structures in some respects, and artifacts of arm's-length contracting in others.

Corporate law's mediative aspect follows from sensitivity to this practice. The doctrine draws on all of the foregoing conceptual bases. In so doing,¹⁷² it avoids the foundationalist error of excluding one basis as a function of respecting another. Instead, it mediates between the various components and norms in the complex, toward the end of mediating between and among the people involved with corporations.

¹⁷¹ Teubner, for example, would advocate an industrial policy. See Teubner, *supra* note 158, at 131.

¹⁷² It does not lapse into relativism in so doing because it accords each basis recognition as an objective force.

Corporate law thus stems in part from the actions and values of the actors involved and, in part, from the state. It is partly mandatory and partly enabling. To structure corporations, it draws on both the model of trust and the model of agency. It also draws freely on both contract and fiduciary principles. It does not adhere to any single positive theory of the firm. It leaves even definitional matters unsettled and subject to mediation.¹⁷³ Different conceptions of the firm, instead of being synthesized in law, are synchronized in time and circumstance.¹⁷⁴ An accurate description of corporate law must account for this mediative aspect.

A mediative approach provides a basis for a satisfying theory only if one reduces his or her expectations about what theory can achieve. To many, good legal theories consistently apply a single or limited foundation. Easterbrook, Fischel, and other contractarians, for example, evaluate explanations of law in terms of instrumental rationality based on the economic welfare goal. To an observer steeped in a methodology of this sort, a mediative description of law at best amounts to a theoretical failure.

Against this reproach can be ranged several advantages. First of all, a mediative approach provides access to a more sensible legal description of the corporation. Methodological correctness does not necessarily enhance a theory's descriptive accuracy. Legal practices, viewed as a whole, are unlikely rationally and consistently to manifest one or another limited conceptual basis. Corporate law certainly has resisted reduction to neat articulations from narrow foundations. Its many apparent inconsistencies persist with undiminished strength despite many attempts to eliminate them through theory.

Oddly, a mediative approach also opens access to corporate legal theory. It allows one to draw on the strengths of different theories even as they compete. Corporate law legitimately may be conceived of as a positive law template for corporate organization with an accompanying rule book. It also may be conceptualized in terms of market contracts, as Easterbrook and Fischel demonstrate. Given a mediative approach,

¹⁷³ The definitional question whether corporations should be conceived of and treated as entities that transcend the presence of individuals who participate in them receives different answers in different legal contexts. In some contexts, entity treatment makes normative and practical sense. In other contexts, firms seem better conceived of as aggregates of relationships between participating actors. Here, once again, positive choices have a normative aspect. Entity treatment may "make sense" in a given situation because of a decision that duties to the group "ought" to obtain. Even the legal definition of the corporation, then, remains a matter of ongoing normative discussion that rests on ethical presuppositions. For detailed discussion of the contingent nature of our positive conceptions of firms, see William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989).

¹⁷⁴ Corporate law also mediates between corporate organizations and the outside world. Here it tends to balance the corporate actors' contract freedom against outside interests. It affords corporate actors great discretion to do business as they see fit, but secures them no right of contract freedom. To the contrary, it imposes a juridical base of limited, conditional contract freedom. See Bratton, *supra* note 173, at 436-46.

neither conception is accorded foundational status, yet neither is disregarded. The insights of both can be considered.

Second, a mediative approach is normatively responsive. Legal mediation uses practical reason to synchronize the competing demands and values of actors through the appeal to legal principle.¹⁷⁵ Legal principles, while they do not provide a track to a single right answer, do offer guidance. They isolate wrong answers¹⁷⁶ and offer information regarding the values at stake in the decision between competing solutions.¹⁷⁷

A mediative conception of the law thus can be useful, despite modest theoretical aspirations. It encourages better understanding of the "tough questions." Where two valid but inconsistent normative directives come to bear on a problem, mediation is required. The choice between the two is a matter of judgment. By articulating the reasons behind a doctrinal inconsistency rather than ignoring or suppressing them, one learns something about the properties of these legal judgments.

The great normative decisions in corporate law occur at these mediative junctures. These are points at which decisionmakers breach enduring conflicts for situational resolution. Closed and consistent legal theories are ill-suited to identify and explain them. And if deep and hidden rationalities inform the law, they do so at these points.

Thus, the assertion is that an inspection of corporate law reveals legitimate, ongoing normative conflicts. Given a legitimate conflict, one can only try to mediate, for theories alone cannot offer directive signals with surety. But identifying the conflict's sources and parameters, including its economics and the other values at stake in their resolution, improves this difficult situation. A legal decisionmaker, thus briefed, renders a judgment of high quality.

Third, a mediative approach keeps legal theory attuned to developments in business practice. Corporate doctrine is mediative in part because decisionmakers take a relational role. They strive to employ norms consonant with those woven into the fabric of the relationships corporate actors bring to them. These norms change over time.

The relational constraint bears importantly on the future of the corporate law. Rules articulated in the past remain appropriate only to the extent that future corporate practices repeat past patterns. Assume, for example, that a particular corporate participation evolved from a basis of relational contract to a basis of discrete contract. Assume also that norms of individual autonomy customarily apply to the new, discrete basis. In this scenario, *The Economic Structure of Corporate Law* would be an appropriate reference for the lawmaker. Reconsideration of any in-

¹⁷⁵ Drucilla Cornell, *From the Lighthouse: The Promise of Redemption and the Possibility of Legal Interpretation*, 11 CARDOZO L. REV. 1687, 1705 (1990).

¹⁷⁶ *Id.* at 1704.

¹⁷⁷ The proposition in the text is the operative assumption of the traditional law teacher who seeks to teach students to be "comfortable with ambiguity."

herited fiduciary norms with a view to abandonment would seem to be indicated. The change in relational pattern causes the continued application of fiduciary constraints to violate the presupposition of respect for the expectations of corporate actors that shaped them in the first place.

Arguably, something akin to this relational-to-discrete transformation has occurred during the 1980s in respect of corporate security holding. The shortening of time horizons, the proliferation of sophisticated holding strategies, the expansion of classes of traded securities, and the corporate restructuring movement together moved relationships to a more arm's-length basis.

Against this dynamic background, Easterbrook and Fischel prompted a reordering of academic corporate law's normative presumptions by bringing to bear ideas that would have been dismissed as absurd two decades earlier. It remains to be seen how much normative force these ideas will carry in the future.

V. CONCLUSION

At least in the context of corporate law, economic analysis has a way of relegitimizing present institutions even as it changes our ways of thinking about them. It is not surprising that *The Economic Structure of Corporate Law* is at its most powerful with its cumulative showing of corporate doctrine's implicit economic rationality. At the same time, the book is least persuasive when it takes reconstructive positions.

The book's—and its methodology's—tendency to confirm the legitimacy of extant legal institutions can mean one of two things. Either the economists' positive assertion is correct and we should expect our existing institutions to be artifacts of narrowly rational self-seeking conduct, or the rationality that informs the calculative exercises of law and economics is based on assumptions shaped by values drawn from an inherited social and political context. One hopes that the next generation of corporate legal theory holds open a place for both possibilities.